

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

ORIGINAL
WITH PROOF
OF SERVICE

77-6091

To be argued by
BERT L. GUSRAE

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

vs.

E.L. AARON & CO., INC., LAWN-A-MAT CHEMICAL &
EQUIPMENT CORP., EDWARD L. AARON, PETER E.
AARON, NORMAN LAWRENCE SCHREIBER, DONALD
DARWIN JACOBSON, DANIEL DORFMAN, FERNANDO
ERAZO,

Defendants,

and

PETER E. AARON,

Defendant-Appellant.

ON APPEAL FROM AN ORDER OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANT-APPELLANT
PETER E. AARON

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(6704)

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PRELIMINARY STATEMENT

This brief is submitted on behalf of Appellant, PETER E. AARON ("AARON"), with respect to his appeal from the opinion and order of the Honorable District Court Judge Lee P. Gagliardi for the Southern District of New York respectively filed May 5, 1977 and May 24, 1977, which permanently enjoined AARON, his agents, servants, employees, attorneys and those persons in active concert or participation with him, from violating the registration and fraud provisions of the Securities Act of 1933 ("Securities Act") as found in Section 5(a)(1), 5(c) and 17(a) of the Securities Act 15 U.S.C. 77e(g), 77(e)(c) and 77g(a), as well as permanently enjoining violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, 17 C.F.R. 240.10b-5 promulgated thereunder.

At the commencement of this action in the District Court, there were originally named eight (8) defendants. All of the defendants, except the Appellant, entered into consent decrees wherein they consented, without admitting or denying the substantive allegations of the Complaint, to the Court's entry of a permanent injunction enjoining future violations of the nature of the acts complained of. Defendant AARON proceeded to defend the allegations made by the Plaintiff, SECURITIES & EXCHANGE COMMISSION ("SEC") against him.

STATEMENT OF FACTS

PETER E. AARON ("AARON") was, at all times relevant, an employee of E. L. AARON & CO., INC. ("AARON & CO."), a registered broker-dealer and member of the National Association of Securities Dealers, Inc., with its main office at 50 Broad Street, New York, New York. His salary never exceeded \$300.00 per week, plus an expense allowance and, during part of the relevant period, was only \$200.00 per week, plus an expense allowance; nor was he ever an Officer, Director, Stockholder, Registered Principal or any other functionary of AARON & CO.

In November 1974, AARON & CO. opened a branch office in Roslyn Heights under the direct supervision and control of NORMAN SCHREIBER ("SCHREIBER"), a Registered Principal. At all times times relevant, AARON worked in the New York City office of AARON & CO.; all of the allegations of misrepresentations in this case were made against SCHREIBER and DONALD JACOBSON ("JACOBSON"), who worked in the Roslyn Heights office. (Roslyn Heights is located in Nassau County, outside of New York City). The District Court made a finding of fact that AARON made no misrepresentations of any kind. 1/

Beginning in late 1974, AARON & CO. and specifically SCHREIBER and JACOBSON, began making a market in the securities of LAWN-A-MAT CHEMICAL & EQUIPMENT CORP. ("LAM"), a New York

1/ S.E.C. v. E. L. Aaron & Co., Inc., CCH Fed. Sec. L. Rep. Para. 96,043 at p. 91,684 (S.D.N.Y. 1977).

Corporation located in Plainview, New York, whose stock is registered with the Securities & Exchange Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934. The due diligence file at AARON & CO. contained copies of LAM's Annual Reports on Form 10-K and other interim reports filed by LAM. LAM's principal business is the selling of lawn care franchises and products; in addition, LAM had acquired options to purchase United Stellar Corporation, Starlight Manufacturing Corporation, Coinmeco and Millcount Realty.

DANIEL DORFMAN was, at all times relevant, the Chairman of the Board of Directors of LAM and Principal Stockholder; prior to April 1975, he was also President (Fernando Erazo was President from April, 1975 until August, 1975). Nina Lane was Mr. Erazo's secretary.

Before making a market in the common stock of LAM, SCHREIBER and JACOBSON conducted a preliminary inquiry into LAM, and obtained information concerning the company directly from DANIEL DORFMAN, and also obtained with the approval of LAM, a stockholder's list, Form 10-K's and other interim filings with the SEC.

In late 1974, a meeting was held at which DANIEL DORFMAN, President, Chairman and Principal Stockholder of LAM, discussed with AARON and others an automobile he planned to have LAM manufacture. At the meeting, DANIEL DORFMAN distributed 8 x 10 photographs of the automobile.

No complaints concerning alleged misrepresentations being made by SCHREIBER and JACOBSON were brought to the attention of LAM, and discussed between LAM and SCHREIBER and JACOBSON, until January, 1975. SCHREIBER, the Registered Principal of the Roslyn Heights office of AARON & CO. was in charge of the Roslyn Heights office and handled the LAM matter at that office. He did not discuss LAM with anyone at AARON & CO.'s main office, nor was it discussed with AARON. At no time was AARON made aware of any alleged misrepresentations made at the Roslyn Heights branch office until a single telephone call was made by MILTON KEEN ("KEEN"), LAM's attorney in April, 1975. AARON then properly referred the matter to SCHREIBER, because SCHREIBER was the Principal in charge of the Roslyn Heights office, where AARON & CO. was making a market in LAM stock.

At all times, SCHREIBER, who was the Principal who was supervising the Roslyn Heights branch office of AARON & CO., emphatically believed in the truth of the statements made to him by DANIEL DORFMAN concerning LAM's prospects for building a car,^{2/} and he so stated to AARON. No misrepresentations to customers or others were ever made by AARON, nor did he induce SCHREIBER, JACOBSON or anyone else to make any misrepresentations. The sole claim of the SEC was that he failed to supervise SCHREIBER, who was himself supervising the Roslyn Heights office, and JACOBSON, who was already supervised by SCHREIBER. Many of the employees

^{2/} Transcript, p. 401.

of AARON & CO. testified that AARON had no supervisory responsibility or duties at AARON & CO. ^{3/} and that, in fact, the firm was run by EDWARD AARON, who was President and sole stockholder of AARON & CO.

In November, 1974, DANIEL DORFMAN sold 1,000 shares of LAM common stock in the open market; and in February, 1974, FRED DORFMAN, a Vice President and Director of LAM, sold 20,000 shares of LAM in the open market. Because the shares were restricted shares under the Securities Act, they were sold pursuant to the exemption from registration afforded by Rule 144, as promulgated by the SEC, for which KEEN provided appropriate opinion letters. The shares were sold by J. W. WELLER & CO. ("WELLER & CO.") acting as agent for the DORFMANS.

Because AARON & CO. was, at all relevant times, the principal market maker in LAM common stock, the shares could not have been sold with AARON & CO., either purchasing directly as principal, or acting as agent for the DORFMANS, owing to the provisions of Rule 144 and the SEC's interpretation thereof. Therefore, the DORFMANS sold the shares through WELLER & CO. as their agent, as required by the SEC, with AARON & CO. purchasing the shares as principal market maker from WELLER & CO. The transactions were effected with the advice of AARON & CO.'s attorney. ^{4/}

^{3/} Transcript, pp. 315-317, 326, 331-332, 366, 369, 426, 430, 434, 435, 467.

^{4/} Transcript, pp. 484-490.

WELLER & CO. was the executing broker for the DORFMANS' sales, evidenced by valid confirmations to its customers (the DORFMANS) and AARON & CO. purchased the shares through WELLER & CO. and not directly from the DORFMANS, as evidenced by valid confirmations/ comparisons. 5/

5/ Defendant's Exhibit "A", Plaintiff's Exhibit 10.

STATEMENT OF ISSUES

1. Should the Trial Court have granted injunctive relief in the absence of a showing that AARON had any legal duty to supervise activities of the branch office of AARON & CO.?

2. Should the Trial Court have granted injunctive relief against AARON as an aider and abettor where the clear weight of the evidence illustrates the lack of underlying misrepresentations?

3. Should the Trial Court have determined that sales of LAM stock violated Rule 144 where the transactions were effected in the manner required by Rule 144 pursuant to SEC's interpretations?

4. Should the Trial Court have granted injunctive relief without properly considering the issue of scienter and distinguishing it from mere negligence?

5. Should the Trial Court have granted injunctive relief in the absence of a likelihood of future violations?

6. Was the injunction by the Trial Court too broad, as the violations it found related to merely one security?

I. THERE WERE NO VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS FOR WHICH AN INJUNCTION COULD BE GRANTED, AS PETER AARON HAD NO RESPONSIBILITY TO SUPERVISE THE ACTIVITIES OF REGISTERED REPRESENTATIVES OF E. L. AARON & CO., INC.

The lower Court made clear in its opinion that AARON himself did not make any misrepresentations with respect to LAM stock: "While Peter Aaron himself did not make any misrepresentations..."^{6/}. Therefore, in order to hold AARON liable for any misrepresentations made by SCHREIBER and JACOBSON, assuming that misrepresentations were made (see infra), it must somehow be determined that AARON, who was never an Officer, Director, Manager, Principal or any other functionary at AARON & CO., had some type of duty to supervise persons at a separate branch office of AARON & CO., located outside of New York City, while he himself worked at the New York City office of AARON & CO.

The fact that the Appellant's last name is the same last name as that of the brokerage house where he was employed is of no probative value whatsoever in the determination of whether or not AARON was under a duty to supervise other employees of AARON & CO.

Two questions which cast insurmountable burdens for the SEC to overcome in its attempt to secure an injunction against AARON rise immediately: 1. On what basis does the SEC assert, and the District Court hold, that AARON had any duty to supervise the activities of other employees of the firm? 2. Even assuming,
6/ SEC v. E.L. Aaron & Co., Inc., CCH Fed. Sec. L. Rep. ¶96,043 at p. 91,684 (S.D.N.Y. 1977).

arguendo, that AARON functioned in some type of managerial capacity at AARON & CO., how can AARON be responsible for alleged violations occurring at a branch office already managed by a Registered Principal?

1. The determination of who must register as a Principal, as opposed to merely a Registered Representative, with a brokerage house which is a member (as was AARON & CO.) of the National Association of Securities Dealers, Inc. ("NASD"), is set forth in the by-laws of the NASD:

"Registration of Principals --All persons associated with a member who are designated as Principals must be registered and must pass a Qualification Examination for Principals before their registration can become effective:

"(1) Persons associated with a member, enumerated in (a)-(c) hereafter, who are actively engaged in the management of a member's investment, banking or securities business, including, supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions, are designated as Principals. Such persons shall include: (a) Sole Proprietors; (b) Officers; (c) Partners; (d) Managers of Offices of Supervisory Jurisdiction, and (e) Directors of Corporations.

"(2) Any person who was registered with the Corporation on or before October 1, 1965, and designated as a Sole Proprietor, Officer, Partner, Manager of Office of Supervisory Jurisdiction or Director is not required to pass a Qualification Examination for Principals, subject to the provisions of paragraph four herein.

"(3) Any person associated with a member as a representative whose duties are changed by the same member after October 1, 1965, so as to require his classification as a Principal will be allowed a reasonable period of time following such change to pass a Qualification Examination for Principals.

"(4) Any Principal whose most recent registration has been terminated for a period of two years or more immediately preceding the filing of a new application shall be required to pass a Qualification Examination for Principals." 7/

There is no evidence that the Appellant ever assumed any of the positions designated in paragraph (1) of the designation of "Principal" (supra). More particularly, AARON never functioned at AARON & CO. as either a Sole Proprietor, Officer, Partner, Manager of an Office of Supervisory Jurisdiction, or as a Director. Consequently, one is hard pressed to discover any basis upon which AARON could have been deemed to be a Principal or to have had any other duty arising from the alleged exercise of such duties. In fact, the SEC never even alleged that AARON was a principal or undisclosed principal.

There is virtually no case law on this particular issue. Recently, the Southern District of New York decided the case of S.E.C. v. E. J. Albanese & Co., Inc. 8/ in which it was held that an employee of a brokerage house could be enjoined as an aider and abettor of bookkeeping violations of the Securities Laws committed by the brokerage house on the basis that the functions performed by the employee made him liable for the underlying violations.

7/ CCH NASD Manual ¶1102A at p. 1051

8/ SEC v. E. J. Albanese & Co., Inc., CCH Fed. Sec. L. Rep. ¶95,778 (S.D.N.Y. 1976).

The Albanese case was decided without any supporting authority. To further distinguish the Albanese decision from the case at bar, Albanese was decided upon findings of fact which began with the conclusion, to wit, that Masiello (the employee in question) functioned in a managerial capacity. Most critically, paragraph 4 of the findings of fact states: "4. Masiello functioned not only as a trader with the company, but had extensive involvement in keeping the books and records made and maintained by the company and functioned in a managerial capacity." (emphasis added) ^{9/}

Functioning in a managerial capacity is the very factual issue which had to be proven based on all the underlying facts.

Moreover, the Albanese case is clearly distinguishable factually from the case at bar. The facts of the Albanese case indicate that Masiello had extensive involvement in keeping the books and records of the brokerage house, including the Net Capital computations and all supporting schedules, purchase and sale blotters, fails, and other books and records, which are the most critical and technical functions to be performed at a brokerage house. In direct contrast to Albanese, the only real evidence which could be adduced with respect to AARON's functions at AARON & CO. were vague and general testimony to the effect that AARON acted as "Assistant to the President" and "the liaison between the operations department, the Registered Representatives and the Trading Room." ^{10/}

^{9/} Ibid at p. 90,813-5.

^{10/} SEC v. E. L. Aaron & Co., Inc. supra at p. 91,682.

Further evidence adduced at the trial did no more than reiterate generalities such as the statements that AARON "conducted sales meetings with Registered Representatives, " "monitored the trading of Representatives," and "participated with his father, in hiring of AARON & CO. employees" and "performed other duties." ^{11/}

In determining that the Appellant functioned as a Principal or other supervisory capacity of AARON & CO., the District Court further erred as a matter of law in refusing to admit into evidence a letter from Dan Brecher, Esq. to the NASD dated August 12, 1971 ("the Brecher Letter"), stating the duties performed by AARON at AARON & CO., and requesting the position of the NASD as to whether or not AARON had to register as a Principal, and the reply of the NASD, dated August 26, 1971, stating that they did not consider him a Registered Principal. ^{12/}

The relevance of the letter of August 12, 1971 and the NASD response of August 26, 1971 is more clearly seen when one considers the NASD criteria for registration of Principals. Sub-paragraph (3) thereof reads as follows: "(3) Any person associated with a member as a representative whose duties are changed by the same member after October 1, 1965, so as to require his classification as a Principal will be allowed a reasonable period of time following such change to pass a Qualification Examination for Principals." ^{13/}

^{11/} Ibid at p. 91,682.

^{12/} Transcript, p. 472, et seq.

^{13/} CCH NASD Manual, Ibid. at p. 1051.

The NASD has the function of determining the standards for registration as a Principal of a member firm. The Brecher Letter to the NASD, if admitted into evidence, would clearly have established to the District Court that, pursuant to the NASD's own guidelines, AARON did not have to register as a Principal, (as determined by the NASD itself pursuant to subparagraph (3) of its provisions concerning Registration of Principals). From such point would have flowed a far more logical and legally cognizable chain of events: The NASD determined that AARON did not have to register in 1971; the evidence adduced at trial determined that his duties in 1974 and 1975 were less than those performed in 1971,^{14/} AARON, therefore, was not functioning as a Principal; AARON, therefore, had no supervisory responsibility over the activities of SCHREIBER and JACOBSON; AARON, therefore, cannot be liable as an aider and abettor.

The lower Court's refusal to admit into evidence the Brecher Letter, which letter represented a forthright attempt by the Appellant to have his status determined by the regulatory body having regulatory responsibility over him, constituted clear error.

2. Assuming, arguendo, that AARON had a duty to register as a Principal, that duty in and of itself conferred absolutely no responsibility upon him to supervise the activities of persons at a separate branch office, which branch office was managed by a Registered Principal in charge of the operations of that branch office.

^{14/} Transcript p. 479.

The SEC's reliance on Samuel A. Sardinia^{15/} is misplaced. In the Administrative Proceeding before the SEC and in Albanese (supra), the violations of the securities laws, if any, occurred in the main and only office of the brokerage house in question. This represents the critical factual distinction of Sardinia and Albanese from the case at bar.

The Registered Principal at AARON & CO.'s branch office where the alleged violations occurred was SCHREIBER. As the Registered Principal of AARON & CO.'s Roslyn Heights branch office, SCHREIBER had all the supervisory responsibilities that the District Court erroneously thrust upon AARON.

In this respect, the District Court critically erred in its fact finding when it stated in Finding of Fact No. 6 "Norman Schreiber ("Schreiber") at all times relevant was associated with Aaron & Co. as a Registered Representative and was branch manager of Aaron & Co.'s Roslyn Heights office."^{16/}

In fact, SCHREIBER was not a Registered Representative at the Roslyn Heights office, he was the Registered Principal at that office, and so testified: "Q. Do you know where that office was?

A. Yes, Roslyn Heights, Long Island.

Q. Do you know when that office was opened up,
if you can remember?

A. Yes. November of 1974, two months later.

^{15/} In the Matter of Samuel A. Sardinia, CCH Fed. Sec. L. Rep. ¶80,501 (1975-1976 Transfer Binder).

^{16/} SEC v. E. L. Aaron & Co., Inc. supra at p. 91,682.

Q. And who was the Registered Principal of that office for E. L. Aaron & Co.? (emphasis added)

A. I was. (emphasis added)

Q. Did you have to take a test to become a Registered Principal?

A. No. I had been previously at a previous firm and it was a carry over. ^{17/}

This error by the District Court in its Findings of Fact creates the misleading impression that there was no Principal at the Roslyn Heights office responsible for the management and activities of that office. In fact, SCHREIBER was the only person responsible for the activities of the Roslyn Heights branch office.

While the establishment of a branch office does not in and of itself carry any implication that its personnel must perform supervisory functions, ^{18/} it is nevertheless true that in the case at bar, SCHREIBER was responsible for managing the Roslyn Heights branch office where the alleged violations occurred:

"Q. And as the Registered Principal, it was your responsibility for managing that particular office."

A. Yes." ^{19/}

Numerous cases hold that where a brokerage house has several principals functioning in a defined area of responsibility, each principal will be held accountable as a principal only within his sphere of responsibility. ^{20/}

^{17/} Transcript, P. 379.

^{18/} CCH NASD Manual, ¶11111 at p. 1066.

^{19/} Transcript p. 380

^{20/} e.g., Schmidt, Sharp, McCabe & Co., Inc. 42 S.E.C. 745 (1965); Midwest Planning Investments, Inc. 42 S.E.C. 558 (1965);

In the case at bar, the alleged violations were not only outside of AARON's sphere of responsibility, assuming arguendo that he had any at all, but were, further, outside the office where AARON was employed. Furthermore, the branch office in question was definitively within SCHREIBER's sole responsibility.

Thus, by illustration, securities law violations committed by the San Francisco office of Merrill Lynch, Pierce, Fenner & Smith, Inc. will not result in an injunction being issued against Merrill Lynch employees at the Miami office. Nor, barring strange and unusual circumstances, will such violations directly affect top level management of Merrill Lynch, Pierce, Fenner & Smith, Inc. A violation at the Roslyn Heights branch office must be considered no more than that. The persons who committed the violations, if any, and those directly responsible for the supervision thereof, have already been the subject of this proceeding and have already consented to judgments against them, without admitting or denying the allegations of the Complaint. There is no basis in law or in fact for going behind the Roslyn Heights, Long Island branch office against an employee of the New York City main branch of the brokerage house who, as a matter of law and fact, had no duty or responsibility to supervise the activities of the Roslyn Heights branch office. The failure of the District Court to so find constituted reversible error.

II. THERE WERE NO UNDERLYING MISREPRESENTATIONS
FOR WHICH APPELLANT COULD BE HELD LIABLE AS
AN AIDER AND ABETTOR.

Even assuming that the Appellant AARON had responsibility to supervise Registered Representatives employed by AARON & CO. and assuming that somehow that responsibility extended to AARON & CO.'s branch office, it is clear that as an aider and abettor, violations of the anti-fraud provisions can only be found when there are underlying violations. It is undisputed that AARON himself made no misrepresentations: "While Peter Aaron himself did not make any misrepresentations..." ^{21/}

The testimony dealing with purported misrepresentations made by the Registered Principal SCHREIBER and the Registered Representative JACOBSON, related primarily to the question of whether or not LAM intended to manufacture cars and tractors. The findings of the District Court, with respect to the LAM car and/or tractor are contrary to the weight of the evidence and this case must be remanded for further proceedings. In its findings of fact, the District Court stated that "LAM, however, was not manufacturing a car or tractor and did not plan to do so." ^{7/ 22/} Footnote 7, to which the above finding of fact relates, reads: "Only Daniel Dorfman, speaking on his own behalf and not for LAM, ever even mentioned a prospective plan that he and not LAM intended to build a car, and he never spoke in the concrete terms described by Schreiber and Jacobson." ^{23/}

^{21/} SEC v. E. L. Aaron & Co., Inc., supra at p. 91,684.

^{22/} Ibid. at p. 91,683.

^{23/} Id.

Such a finding is unsupported by the record. On cross-examination, DANIEL DORFMAN testified as follows:

"O. Let me rephrase that.

In 1973, did Lawn-A-Mat acquire certain companies?

A. Yes.

Q. What were the names of those companies?

A. United Stellar, Starlight Manufacturing Company, Coinmeco, Milcount Realty and Sheridan Realty.

Q. Wasn't the purpose of the acquisition of these companies to obtain facilities for the production of automobiles and tractors back in 1973?

A. Yes.

Q. In these facilities was there a major plant out in Kansas City?

A. Yes.

No, I'm sorry, it was Joblin.

Q. And the plant in Plainview, how would you describe that?

A. It was a very large, very well-equipped manufacturing facility.

Q. And then did there come a time when there were problems in 1973 with respect to this concept of producing a car and a tractor?

A. No.

Q. In 1974 was there some litigation between you and the former owners?

A. Yes.

Q. And as a result of that litigation was a new arrangement worked out between Lawn-A-Mat and the prior owners of United Stellar, Starlight and the related companies?

A. Yes.

Q. Would you describe for the Court what that new arrangement was?

A. Well --

Q. In your words. I know it is very complex legally.

A. It is a very complex situation. I'm trying - in 1974, after the deal fell through and we were in litigation, Mr. Discount and myself got together and determined that the best interests of all the parties would be served by going forward with what we had originally planned, and we made whatever-- took whatever steps were necessary to stay the litigation, and Lawn-A-Mat again was restored to its original position as owner of the plant, subject to the approval of the stockholders.

Q. And did you personally take it on yourself to assume Lawn-A-Mat's position temporarily?

A. Not at that time.

Q. Later did you do that?

A. Later I did, yes.

Q. And you granted Lawn-A-Mat an option on your position for one year?

A. Yes, I did.

Q. And was it always your intention that if you went into the actual production of a car and a tractor that this would be for Lawn-A-Mat?

A. Yes." ^{24/}

DORFMAN further testified:

"Q. Did there come a time in the latter part of 1974 where you had put together what you felt were the right people and the parts to go ahead with this production, proposed production, of the tractor and the car?

A. Sorry. What year?

Q. The end of 1974.

A. No, it was 1973, September 1973 we have everything ready to go.

Q. And then there were some problems?

A. Yes.

Q. And then did there come a time subsequently when you had put things back together again?

24/ Transcript, pp. 259-252.

- A. Not sufficiently to seriously consider a car, but definitely to build the Lawn-A-Mat equipment and the tractors.
- Q. And wasn't it a fact that the tractor and the car were very similar in their components?
- A. Yes, many of the components were similar.
- Q. Were a number of those components parts you had purchased from the old Crosley automobile manufacturer?
- A. Well, not quite. Crosley, when Crosley went out of business in the forties, they continued to make the mechanical components, transmissions, drive shafts, rear ends. The tractor that we used, the Economy tractor, is the Crosley just cut down, using all the mechanical components, and my thought was to start building tractors, which would be the basic component of the automobile, and expanded to a car, with a plastic body.
- Q. And this plastic body, could this have been produced on this machine in Kansas City?
- A. Yes.
- Q. And did you feel that with respect to the tractors that you were considering for production, that there was a significant market for those tractors?
- A. Yes. The Lawn-A-Mat use alone warranted the setup, set up of the assembly line, and there is sufficient market for other uses, too, to have made it, I believe, a highly profitable item.

Q. And also this could be done in conjunction with the production of combines?

A. Yes, because we needed one tractor for each combine.

Q. The combine that you described, was that what you described in direct testimony as what made this particular industry possible?

A. That is correct.

Q. Now, with respect to the car, was this supposed to be a plastic body car?

A. Yes.

Q. Was it projected to retail at a price of approximately \$1500?

A. Yes.

Q. Was this gasoline-powered by a 2-cylinder Onan engine?

A. Yes.

Q. Was it a low compression or a high compression engine?

A. Low compression.

Q. And what was the estimated miles per gallon?

THE COURT: Is all of this necessary?

MR. HECHT: Well, yes, because I think it goes, your Honor, to the direct testimony of what the representation --

THE COURT: The miles per gallon and everything else? I don't think that has anything to do with it.

The question is whether they were going to make a car or not, isn't it? What the compression ratio and what the size of the tires were, and the transmission, I don't think is relevant here one bit at all.

All right, let's proceed.

MR. HECHT: I will try to limit it, your Honor.

THE COURT: All right.

Q. Was it always your intention that if and when this car was manufactured that Lawn-A-Mat would have the benefit of it?

A. Yes.

Q. And did you feel and state that the Lawn-A-Mat dealers and franchisees were a built-in national sales organization?

THE COURT: State to whom?

Q. Let's say to the dealers and franchisees.

A. I don't recall that I stated this specifically, ^{25/} but it is true."

Later still, DORFMAN testified:

Q. Do you recall what was discussed at that meeting between you and Peter Aaron?

A. Not specifically.

Q. Did you show Mr. Aaron pictures of the car at that meeting?

A. Probably.

^{25/} Ibid., pp. 253-257.

Q. And how did you describe the car to Mr. Aaron?

A. Well, I told Mr. Aaron and whoever was there about Lawn-A-Mat, which was our primary purpose in meeting, and the subject of the acquisitions came up, and I believe at that time we had just reacquired our position, and I told him about my previous plans and whatever --

Q. Do you recall any discussions with Mr. Aaron relating to the proposed production of a tractor?

A. At that time, not specifically. But if we were talking I would have told him all of my plans.

Q. Did you ever show pictures of these cars to Don Jacobson?

A. Yes.

Q. Did you ever describe the car to Don Jacobson?

A. Yes." 26/

All of this testimony was corroborated by Norman Schreiber:

"Q. And do you recall what Mr. Dorfman said at that meeting?

A. Yes. He talked about a car he intended to build and produce with Lawn-A-Mat, and he then had pictures with him of the car, colored photographs, I guess they were, 8 x 10s, or some, you know, nice-looking size, and it looked very promising and we spoke about it, I guess, you know, 20 minutes to a half hour, whatever, in this little room in a meeting.

26/ Ibid., pp. 258-259

Q. Do you recall him showing pictures of the car to Peter Aaron?

A. Yes, we all looked at them. They were distributed to Edward and Peter.

Q. And did he describe anything, how Lawn-A-Mat was going to produce this car at that meeting, if you can recall?

A. He told us there was a plant somewhere in the Middle West, in Joplin, I think it was. In fact, he had a picture of a tremendous machine that he said was the only one of its kind, built by IBM, and he had a picture of this, showing this machine molding plastic bodies." 27/

Further testimony was adduced from SCHREIBER with respect to the intended manufacture of the automobile on behalf of Lawn-A-Mat:

"Q. Okay. Now, you said you visited the facilities on a number of occasions. Would you describe to the Court when you can recall your next visit to the premises and how you met there?

A. Well, another visit which may be was a month or two later was with Mr. Dorfman, Mr. Jacobson, myself and a chap from a public relations firm. I absolutely don't remember his name or the name of the firm. But he was called there by Mr. Dorfman because at the time he felt he wanted to publicize the car and put public relations on it. And he invited us, us

meaning Mr. Jacobson and myself, to come and listen to this presentation, and he talked, after giving us another tour and showing the car to the public relations chap, went back into his office and he spoke mostly to him about different types of public relations and what he could do and what the other one can do and --

Q. Do you recall what they said about the car as far as its characteristics?

A. Well, Dorfman had told him it was going to run not on gasoline but on, I believe, electric, and it would get, oh, a lot of miles per gallon. I think the number was 40 or 50, and it would be very economical, and it would cost -- the initial cost was, I think, somewhere in the 2,000 to \$2,500 price category, the purchase, and they would have different models, and there was one, I think they were using a transmission which had something to do with a Crosley. I remember the name Crosley in there. It may not have been pertaining to transmission, but it was something from a Crosley car." ^{28/}

Later, when asked about complaints with respect to his activities in connection with the sale of Lawn-A-Mat common stock, Mr. Schreiber testified that Nina Lane called him (Schreiber) to find out why he was telling people about a car. ^{29/} Mr. Schreiber then testified

^{28/} Ibid, pp. 397-398

^{29/} Ibid, p. 407.

that he called Mr. Dorfman who told him not to worry about it
because he (Dorfman) "emphatically told me they were [building a
car]." 30/

30/ Id.

III. THE SALES OF LAWN-A-MAT COMPLIED WITH THE PROVISIONS OF RULE 144, AND, THEREFORE, PETER AARON DID NOT VIOLATE SECTION 5 OF THE SECURITIES ACT OF 1933

Section 5 of the Securities Act provides that it is illegal to sell securities unless a registration statement is in effect as to the securities or there is an applicable exemption from the registration requirements of Section 5.

The sales of 21,000 shares of LAM restricted common stock by the DORFMANS were made without the stock having been registered pursuant to a registration statement. Therefore, Section 5 of the Act was violated unless some exemption from registration was available with respect to such sales.

The District Court in this case erred when it stated that "the burden of establishing the availability of an exemption from the requirements of Section 5 is on AARON, the one claiming the exemption." ^{32/} Under the Securities Act, there is no "burden" whatsoever upon AARON to establish an exemption from registration and neither he or AARON & CO. must make any "claim" for exemption. The burden of establishing the availability of an exemption from the requirements of Section 5 (supra) of the Securities Act rests upon the seller of the stock and upon the selling broker. ^{33/} Rule 144 imposes no burden whatsoever on the buyer of stock sold pursuant to Rule 144, i.e., AARON & CO. herein and, a fortiori, no burden is placed on the Appellant.

^{31/} 15 U.S.C. 77e.

^{32/} SEC v. E. L. Aaron & Co., Inc., Ibid. at p. 91,685.

^{33/} 17 C.F.R. 230.144

Rule 144, in conjunction with Section 4 ^{34/} and Section 2(11) ^{35/} of the Securities Act, allows the public sale of unregistered securities (as sold by the DORFMANS) if the sale is made in compliance with all of the conditions of Rule 144. The only provisions of Rule 144 which are in dispute in the case at bar are subsections 144(f) ^{36/} and 144(g) ^{37/}

Rule 144 (f) provides as follows:

"(f) Manner of Sale. The securities shall be sold in "brokers' transactions" within the meaning of Section 4(4) of the Act and the person selling the securities shall not (i) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transactions or (ii) make any payment in connection with the offering or sale of the securities to any person other than the broker who executes the order to sell the securities." ^{38/}

This subsection places the burden upon the person selling the securities -- in this case the DORFMANS -- to make sure that their sale of unregistered securities is in compliance with the Rule, i.e., that the seller of the unregistered securities may not solicit or arrange for the solicitation of orders or make any payment in connection with the offer or sale to other than the broker who executes the order to sell the securities. It is clear that the burden of complying with subsection (f) of Rule 144 rested with the

^{34/} 15 U.S.C. 77d.

^{35/} 15 U.S.C. 77b(11).

^{36/} 17 C.F.R. 230.144(f).

^{37/} 17 C.F.R. 230.144(g).

^{38/} 17 C.F.R. 230.144(f).

the seller of the unregistered securities, i.e., the DORFMANS and not with AARON, AARON & CO., J. W. WELLER & CO. or any other person. Subsection (g) of Rule 144 provides as follows:

"(g) Brokers' Transactions. The term 'brokers' transactions' in Section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker --

- (1) does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; and receives no more than the usual and customary broker's commission;
- (2) neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; provided, that the foregoing shall not preclude (i) inquiries by the broker of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days, (ii) inquiries by the broker of his customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days; or (iii) the publication by the broker of bid and ask quotations for the security in an inter-dealer market for the security for the broker's own account and that the broker has published bona fide bid and ask quotations for the security in an inter-dealer quotation system on each of at least twelve days within

the preceding thirty calendar days with not more than four business days in succession without such two-way quotations..." ^{39/}

In citing subsection (g) of Rule 144, the District Court overlooked sections (i) and (ii) (supra) and dismissed them as viable exemptions to Section 5 of the Securities Act by categorizing them as "certain exceptions not relevant here..." ^{40/} For reasons which the Court did not explain, the so called "certain exceptions not relevant here" are, in fact, the very exceptions which prove that the DORFMANS' sales of unregistered securities were not in violation of Section 5 of the Securities Act, and, therefore, neither AARON & CO. nor, a fortiori, AARON, can be held legally accountable for the DORFMAN sales of LAM registered stock.

Emphasizing that the burden of complying with Rule 144 is upon the selling stockholder (discussed with reference to subsection (f) of Rule 144 above), and upon the broker executing the transaction, Rule 144(g)), in the case at bar, the executing broker, WELLER & CO. (and not AARON & CO.) did, in fact, comply with Rule 144(g)(2)(i), in that it sold the securities without soliciting orders for its customers (the DORFMANS), because subsection (i) allows inquiries by the executing broker (WELLER & CO.) of other brokers (AARON & CO.) who have "indicated an interest in the securities within the preceding 60 days." ^{41/} It is undisputed that WELLER & CO. was the executing broker of the DORFMANS' transactions. Whether or not

^{39/} 17 C.F.R. 230.144(g)

^{40/} SEC v. E. L. Aaron & Co., Inc., Ibid. at p. 91,685.

^{41/} 17 C.F.R. 230.144(g)(2)(i).

WELLER & CO. became the executing broker because of AARON & CO.'s recommendation is of no consequence under Rule 144. The District Court erred when it found that AARON & CO. was not acting "as agent" for the DORFMANS but that AARON & CO. was the executing broker in the 144 transaction.^{42/} There is not a scintilla of evidence in the record which indicates that the "executing broker" of the sale of DORFMANS' registered share of LAM was sold by any broker other than WELLER & CO. All of the comparisons admitted in evidence from both brokerage houses (WELLER & CO. and AARON & CO.) indicate that WELLER & CO. was the executing broker, and further, DANIEL DORFMAN testified that WELLER & CO. was the executing broker^{43/} as agent for the DORFMANS. The SEC did not produce any evidence to the District Court indicating that AARON & CO. was, in fact, the executing broker, nor was counsel to LAM, who issued an opinion letter, aware of any improprieties whatsoever.^{44/}

Rule 144(g) merely sets forth the circumstances under which the executing broker, WELLER & CO. (and not AARON & CO.) can solicit other customers or brokers without violating the Rule. It is clear from the Rule that the burden of compliance with subsection (g) rested with WELLER & CO., the executing brokerage house which complied with the Rule.

The SEC contended and the District Court accepted the position that WELLER & CO. as a so-called "intermediary" in the transaction was no more than a "sham to evade the intent of the Rule while feigning technical compliance."^{45/} Yet, corroboration that

^{42/} S.E.C. v. E. L. Aaron & Co., Inc. Ibid at p. 91,685

^{43/} Transcript, p. 310.

^{44/} Ibid. at p. 2-1-212.

^{45/} SEC.v. E. L. Aaron & Co., Inc., Ibid. at pp. 91,685-91,686.

the sale of LAM stock by the DORFMANS through WELLER & CO. to AARON & CO. complied with Rule 144(g) is found in "no action" letters issued by the SEC itself.

The Division of Corporation Finance of the SEC has, from time to time, issued interpretive letters ("no action" letters) in response to requests from various persons concerning the applicability and interpretations of the securities laws as to certain transactions. Two of these so-called "no action" letters issued by the SEC speak directly to the issue of compliance with subparagraph (g) of Rule 144. In Herzog & Co. Inc.,^{46/} the Division of Corporation Finance stated its view that the proposed execution of Rule 144 sales by a specialist acting on behalf of its customers, accomplished through the purchase of the shares for the account of the specialist, fails to qualify as a "brokers' transaction" within the meaning of subparagraph (g)(1) of Rule 144. The staff of the SEC stated that regardless of the possible characterizations of the specialist's role in the transaction, the specialist, in actually purchasing the shares, would clearly be acting as a principal and not as an agent in violation of Rule 144.

It is the Appellant's position, as specifically directed by the SEC's staff itself in the Herzog & Co., Inc. "no action" letter that the actual purchase by AARON & CO. of the DORFMAN shares directly from the DORFMANS and their subsequent sale by AARON & CO. to its customers, would not qualify as a "brokers' transaction" under subparagraph (g)(1) of Rule 144. Consequently, when the DORFMANS desired to sell their shares, and were familiar only with AARON & CO.

^{46/} Herzog & Co., Inc. CCH Fed. Sec. L. Rep. ¶79,801, 1973-1974 Transfer Binder (available May 15, 1974)

(the principal market maker in the stock), ^{47/} it was legally impossible for AARON & CO. itself to purchase the DORFMAN stock directly from the DORFMANS for two reasons:

First, purchase by AARON & CO. directly from the DORFMANS as principal is directly in violation of subparagraph (g)(1); Second, as AARON & CO. was the principal market maker of LAM stock, it would have been virtually impossible to sell the shares without violating subparagraph (g)(2) of Rule 144, which allows "brokers' transactions" provided that the broker "neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction."

In other words, since AARON & CO. was actively making a market in LAM stock, and soliciting its customers, the sale of the DORFMANS' stock to any customer who had been solicited would have clearly violated Rule 144(g)(2). It was, and still is, legally impossible for a brokerage house actively making the principal market in securities of a company whose stock is being publicly traded to execute Rule 144 transactions without violating Rule 144.

Most important, and dispositive of the legal issues raised herein, the Division of Corporation Finance recently interpreted Rule 144, interpreting proposed stock transactions identical to the DORFMANS' sale of LAM stock. In Carolina Securities Corporation ^{48/} a brokerage house which was apparently the only market maker in the stock being sold, was prepared to purchase a significant amount of restricted stock of that particular issuer, but requested corroboration from the SEC to the effect that the only way a customer

^{47/} Transcript, p.454

^{48/} Carolina Securities Corporation, CCH Fed. Sec. L. Rep. ¶80,803, 1976-1977 Transfer Binder (available October 7, 1976).

of that brokerage house could sell such Rule 144 stock would be "by going to another broker-dealer who is not a market maker," and in such manner, "the stock can be sold readily with the broker acting as agent and our [Carolina Securities Corporation] buying the stock."^{49/} Carolina Securities Corporation stated that it seemed somewhat unfair, because its selling customer would probably receive a lower price as a result of the commission paid; further, it also seemed unfair that Rule 144 would actually force a customer of one brokerage house to do business elsewhere. The SEC confirmed such an arrangement, stating specifically that "the broker may not solicit buy orders, but may inquire of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days."^{50/} The letter further went on to state that the interpretation of Carolina Securities Corporation was indeed correct.

Carolina Securities Corporation then requested further clarification from the SEC which it received shortly thereafter.^{51/} In its second letter to the SEC, Carolina set forth a specific example to establish again what it believed to be the correct interpretation of "brokers' transactions" under Rule 144: a customer contacted Carolina, desiring to sell 5,000 shares of stock of an issuer for which Carolina was the principal market maker and probably the only broker willing to buy 5,000 shares. Because Carolina's customer was an affiliate of the issuer, it was concluded that the sale was subject to Rule 144. Carolina was certain it could not purchase as principal, since such a purchase is specifically prohibited by Rule 144.^{52/}

^{49/} Ibid., p. 87,095

^{50/} Ibid., p. 87,094.

^{51/} Carolina Securities Corporation CCH Fed. Sec. L. Rep. ¶80,856, 1976-1977 Transfer Binder (available December 8, 1976).

^{52/} Subsection (g)(1) of Rule 144 provides that the executing broker may only sell the shares as agent for the selling stockholder.

Further, it could not sell the shares as agent because it could not find a buyer other than its own previously solicited customers and such a transaction would have been clearly violative of subsection (g)(2) of Rule 144. As Carolina wrote, "therefore, if our customer contacted another broker/dealer, he (the broker) would be able to sell us the stock, acting as agent for the seller and apparently comply with the requirements of the Rule in respect to brokers transactions."^{53/} Carolina then asked directly "would not the sale of the stock through another broker/dealer acting as agent comply with Rule 144 even though the broker/dealer sells the stock to Carolina Securities Corporation?"^{54/}

The SEC, in its response, specifically agreed that the transaction proposed by Carolina could only be effected through another broker/dealer, even though the customer who sold the restricted securities would probably receive less money for his shares because he would have to pay a commission to the selling broker: "since the Rule provides that the securities shall be sold in brokers' transactions within the meaning of Section 4(4), a Rule 144 seller would, therefore, presumably pay commissions to any broker/dealer acting as agent as required by Section 4(4)."^{55/}

The SEC then continued in its response: "A prohibition is set forth in paragraph (g)(2) of the Rule as to transactions in which a broker 'neither solicits nor arranges for the solicitation of customers orders...'. A broker is otherwise free to sell to any broker/dealer; a broker/dealer purchasing as principal from another

^{53/} Ibid., p. 87,257.

^{54/} Id.

^{55/} Id.

broker/dealer is in the position of any other purchaser of Rule 144 stock." ^{56/} (emphasis added).

As a matter of law as specifically interpreted by the SEC in the Carolina letter, (supra), when the DORFMANS wanted to sell their restricted stock, they were prohibited from selling directly to AARON & CO., and were forced to use an intermediary broker (in this case WELLER & CO.). Even though this construction of Rule 144(g) may force a customer to use a brokerage house with which he is not familiar, and even though the customer may receive less for his shares because he has to pay a brokerage commission, the SEC itself nevertheless stated that "we are not persuaded that the Rule should be modified at the present time." ^{57/}

It is undisputed that the DORFMANS sold their stock through WELLER & CO. Valid confirmations were executed by WELLER & CO. to the DORFMANS. It is further undisputed that WELLER & CO. thereafter sold the shares to AARON & CO. The transaction as executed was not only consistent with Rule 144, it was mandated and approved of by the SEC's position as set forth in Carolina Securities Corporation (supra). On the one hand the SEC in Washington states that such sales must be made through another brokerage house; on the other hand, the SEC contends in this case that such sales cannot be made through another brokerage house. How then can such sales be made at all? Rule 144 was promulgated and adopted by the SEC, and is interpreted by the SEC. In contending that the sales in this case were a "sham", when Carolina requires that sales be made in this manner

^{56/} Id.

^{57/} Id.

the SEC is being capriciously and intellectually dishonest by disregarding its previous interpretations of Rule 144.

The conclusory language of the District Court in this case-- "this conduct was not in compliance with Rule 144 and as a result Defendant has not met his burden of establishing an exemption to Section 5 of the Securities Act" ^{58/} --cannot go unmodified when the Court's conclusion is given without reason and without any basis in law. The District Court further erred by compounding its unfounded conclusions with a footnote to the effect that "this holding is consistent with the Commission's position in its staff interpretive letters clarifying the meaning and application of Rule 144. Carolina Securities Corp.., CCH Fed. Sec.L. Rep. 80,803 (October 7, 1976) and 80,853 (December 8, 1976...)." ^{59/} The District Court's holding is not only inconsistent with the SEC's position in Carolina, it is directly contradictory to the Carolina interpretive letter (supra). Accordingly, the District Court erred as a matter of law.

^{58/} S.E.C. v. E. L. Aaron & Co., Inc. supra at 91,686.

^{59/} Id.

IV. THE LOWER COURT ERRED IN GRANTING INJUNCTIVE RELIEF IN THE ABSENCE OF SCIENTER, AS SCIENTER IS A NECESSARY ELEMENT OF PROOF IN S.E.C. ENFORCEMENT ACTIONS.

In the landmark case of Ernst & Ernst v. Hochfelder,^{60/} the United States Supreme Court held that scienter is a necessary element to be proven in private actions under the anti-fraud provisions of the Securities Exchange Act of 1934. In addition, other Federal Courts have followed the reasoning in Hochfelder, by holding that scienter is also a necessary element which must be proven for the SEC to secure injunctive relief,^{61/} and in private actions brought under the Securities Acts.^{62/}

All of these cases point to the necessity of scienter--"an intent to deceive, manipulate or defraud"^{63/} -- as a necessary element of proof in actions brought under Section 17a of the Securities Act or Section 10(b) of the Exchange Act. Nevertheless, the District Court in this case held: "...negligence alone may suffice as a standard for liability in Commission enforcement proceedings...."^{64/} The District Court's blurring of the scienter/negligence dichotomy exemplified the District Court's misunderstanding of the standards

60/ Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)

61/ S.E.C. v. American Realty Trust, CCH Fed. Sec. L. Rep. ¶95,813, 1976-1977 Transfer Binder (E.D. Va. 1977); SEC v. Bausch & Lomb, Inc. CCH Fed. Sec. L. Rep. ¶ 95,722, 1976-1977 Transfer Binder (S.D.N.Y. 1976), aff'd on other grounds, CCH Fed. Sec. L. Rep. ¶96,186, Current Binder (2d Cir. September 30, 1977).

62/ Sanders v. John Nuveen & Co., Inc. CCH Fed. Sec. L. Rep. ¶96,030, Current Binder (7th Cir. 1977); Malik v. Universal Resources Corp. CCH Fed. Sec. L. Rep. ¶96,055, Current Binder (S.D. Cal. 1977).

63/ Ernst & Ernst v. Hochfelder, supra at 193.

64/ SEC v. E. L. Aaron & Co., Inc., supra at 91,685.

of proof for injunctive relief. Was this District Court creating a "constructive scienter" standard? Curiously, this above quoted statement by the Court that negligence alone might suffice was followed by several citations one of which was "contra SEC v. Bausch & Lomb, Inc., CCH Fed. Sec. L. Rep. Sec. 95,722 (S.D.N.Y.1976), Appeal Docketed No. 73 Civ. 2458 (2d Cir. September 16, 1976)." ^{65/} The Bausch & Lomb case was cited without any explanation whatsoever, and without any recognition that the decision in Bausch & Lomb may have effectively changed the law in this Circuit with respect to the necessity of finding scienter.

On September 30, 1977, the Second Circuit affirmed the Bausch & Lomb decision, but on other grounds. ^{66/} The issue of scienter was thus deferred in this Circuit. Nevertheless, although the Second Circuit did not have to decide such an issue in Bausch & Lomb, it is squarely before the Circuit again in the case at bar. And, as the Second Circuit may have hinted in Bausch & Lomb, it is time to abandon the old, Pre-Hochfelder ^{67/} rule that negligence will suffice in an SEC injunctive action. In fact, the Second Circuit studiously avoided

^{65/} Id.

^{66/} SEC v. Bausch & Lomb, Inc. CCH Fed. Sec. L. Rep. ¶96,186, Current Binder (2d Cir. September 30, 1977.)

^{67/} SEC v. Management Dynamics, Inc., 515 F. 2d 801,809 (2d Cir. 1975); SEC v. Spectrum, Ltd., 489 F. 2d 535,541 (2d Cir. 1973); SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 854-55 (2d Cir. 1973) (en banc), cert. denied, Coats v. SEC, 394 U.S. 976 (1969).

reference to its own post-Hochfelder decision in SEC v. Universal Major Industries Corp.,^{68/} and in Arthur Lipper v. SEC.^{69/}

At the very least, this Court should follow the October 3, 1977 holding in Nassar and Company, Inc. v. SEC,^{70/} which remanded an SEC proceeding for reconsideration in light of Hochfelder, as to whether or not scienter must be established in an administrative proceeding. The Court of Appeals for the District of Columbia recently remanded yet another case for the same reason:

"The applicablility of the Hochfelder decision to enforcement actions brought by the SEC is a question that has not been decided by this Court. In addition, we have before us only the views of the attorneys representing the Commission, and not the Commission itself, as to the applicability of the Hochfelder scienter requirement in actions of this type. We emphasize that we intimate no view as to the applicablility of the Hochfelder scienter requirement in this case. We hold only that the actions of the petitioners must be re-evaluated in light of significant Supreme Court precedents rendered since petitioners' case was decided by the Commission."^{71/}

If one thing is clear from Hochfelder, American Realty Trust, Nassar and Collins Securities, it is that the law is in a great state

68/ SEC v. Universal Major Industries Corp. (1976-1977 Transfer Binder) CCH Fed. Sec. L. Rep. ¶95,804.

69/ Arthur Lipper Corp. v. SEC (1976-1977 Transfer Binder) CCH Fed. Sec. L. Rep. ¶95,796.

70/ Nassar and Company, Inc. v. SEC, CCH Fed. Sec. L. Rep. ¶96,186 Current Binder (D.C. Cir. October 3, 1977).

71/ Collins Securities Corp. v. SEC No. 75-2200, slip op. at 13-14 (D.C. Cir., August 12, 1977), cited with approval in Nassar and Company, Inc. v. SEC, supra Note 70 at 92,342.

of flux. Without question, the case at bar should at the very least be remanded, as Collins Securities, for further proceedings to clarify the scienter issue.

Moreover, in light of Hochfelder, and particularly the Supreme Court's reasoning in that case, as further explained in American Realty Trust, it is time for this Circuit to clarify and hold that scienter must be proven in SEC injunctive actions. Although the Supreme Court in Hochfelder declined to make such a finding because that issue was not before it,^{72/} the Court in American Realty Trust did wisely conclude that scienter, as required in private actions, must also be required in SEC enforcement actions:

"If the language and history of 10(b) is dispositive as to a scienter requirement in private actions, it must also be so for SEC enforcement actions, since such suits are creatures of statute rather than implied rights of action."^{73/}

Since these actions are creatures of statute, then, necessarily, they must stand or fall on the statute itself. The Supreme Court has now determined that scienter is required to be proven in a private right of action. It is of no consequence who the plaintiff is. How can scienter now be required merely because the SEC is the plaintiff rather than a private party?

72/ Ernst & Ernst v. Hochfelder, supra at 193-194 n.12

73/ SEC v. American Realty Trust, supra at p. 91,440.

V. THE DISTRICT COURT'S FINDINGS ARE INADEQUATE
TO SHOW SCIENTER

The District Court's findings with respect to scienter are wholly inadequate to sustain a holding of scienter on the part of the Appellant.

With respect to the District Court's findings concerning violations of the anti-fraud provisions of the Securities Law, the Court erred as a matter of law in refusing to admit into evidence the Brecher Letter (August 12, 1971) written to the NASD, which letter described the duties performed at that time by the Appellant, AARON, and the reply of the NASD dated August 26, 1971, stating the position of the NASD that AARON did not have to register as a Principal based upon the services he was performing for AARON & CO. ^{74/}

As explained in Section I of this brief, it is the NASD which has the responsibility of establishing the criteria for determining who must register with the NASD as Registered Representatives, Principals, or not at all. The NASD's determination is, therefore, crucial to the Court's determination whether or not AARON, as a matter of law, was required to register as a Principal with the NASD. The refusal to hear such evidence constituted reversible error on the part of the District Court.

Further, the findings of the Court with respect to the alleged false and misleading representations concerning the common stock of LAM made by certain salesmen employed by AARON & CO. were completely inadequate to support a holding that AARON, with scienter, aided and abetted violations by the salesmen.

^{74/} Transcript pp. 471-475.

In order for the District Court to have enjoined AARON as an aider and abettor, it was necessary for the District Court to have found the underlying violations of the Securities Laws, the obligation of AARON to supervise Registered Representatives, and, by reasoning of the Hochfelder and American Realty Trust decisions, an intent to deceive, manipulate or defraud. (Noteworthy is the fact that Section 21(e) of the Exchange Act makes no specific statutory provision to enjoin aiders and abettors). The statement by the Court that "Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the Securities Laws,"^{75/} is reversible error as a matter of law, and is also totally unjustified by the evidence adduced at trial. The testimony indicates that AARON did not know that the statements made by SCHREIBER and JACOBSON were false, but that he (AARON) in fact believed them to be true. In fact, the entire "case" against AARON amounts to two telephone calls from KEEN, attorney for LAM (and not a principal of the company), as opposed to AARON's attending a presentation by LAM's Chairman and Principal Stockholder regarding proposed manufacture of an automobile for LAM. SCHREIBER testified that the automobile in question was being developed on behalf of LAM.^{76/} Further, the statement that AARON intentionally refused to terminate such statements is unsubstantiated by the record. He attended a meeting inquiring into the matter,^{77/} and listened to a presentation by LAM's President concerning the manufacture of a car.

^{75/} SEC v. E. L. Aaron & Co., Inc., supra at p. 91,685.

^{76/} Transcript p. 422.

^{77/} Transcript pp. 258, 383, 438.

Therefore, a finding that he intentionally failed to terminate the statements made by SCHREIBER and JACOBSON, assuming, arguendo, AARON had had such a duty to do so, is wholly without support on the record.

As to the Rule 144 transactions, with respect to the findings by the District Court that Appellant acted "with knowledge or reckless disregard of the illegality of the arrangement with the DORFMANS and WELLER & CO. "^{78/}, the District Court erred as a matter of law in stating that AARON acted with knowledge of the illegality of the transaction. In fact, as set forth earlier in this brief and as adduced at the trial, he believed that the Rule 144 transactions in question were legal, and, further, he acted on the advice of counsel. While the District Court correctly stated the law that "good faith reliance on advice of counsel may be a factor to consider in deciding whether to grant injunctive relief, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1101,"^{79/} the Court failed to make any finding whatsoever that such a defense could be raised directly in response to the issue of scienter.

Good faith reliance on counsel as a matter of law is a valid defense.^{80/} At the least, good faith reliance on counsel should negate any finding of scienter, even if the advice is not followed, unless it can be found that the reliance on counsel is, in itself, made with intent to deceive, manipulate or defraud. In this case, it is undisputed that Appellant discussed with his attorney the manner of executing Rule 144 transactions^{81/} and believed he was

^{78/} SEC v. E. L. Aaron & Co., Inc., supra t p. 91,686.

^{79/} Id.

^{80/} Williamson v. United States, 207 U.S. 425-453 (1908); SEC v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1101-1102 (2d Cir. 1972); U.S. v. Hill, 208 F. Supp. 1221, 1235 (D.C. Conn. 1969).

^{81/} Transcript p. 483-486.

acting on counsel's advice. As a finding of scienter is required it is incumbent upon the District Court to make a specific finding, pursuant to the Federal Rules of Civil Procedure, as to whether or not the Appellant's seeking of advice of counsel was itself made with intent to manipulate, deceive or defraud. For if good faith reliance on advice of counsel is a factor to consider in deciding whether to grant injunctive relief if scienter is not required, then, a fortiori, it is not only a factor to consider where scienter is required, it is a crucial element on which specific findings must be made.

The District Court's limited findings of fact regarding advice of counsel, holding that counsel for AARON & CO. never advised AARON that the arrangement with WELLER & CO. to act as prearranged intermediary in the sale of the DORFMANS' stock was in compliance with Section 5 of the Securities Act,^{82/} does not satisfy the requirements of Rule 52 of the Federal Rules of Civil Procedure that the Court make specific findings of fact. More particularly, the Court made no findings with respect to the kind of advice given by counsel for AARON & CO., which advice, as will be discussed infra, was considerable and specific.

In addition to failing to make specific findings of fact which were crucial to the scienter issue, the District Court erred in finding that there was no reliance on the advice of counsel because defendant did not follow such advice. The testimony of Dan Brecher, Esq., counsel to AARON & CO. illustrates that the transactions in LAM common stock were effected in accordance with Mr.

^{82/} SEC v. E. L. Aaron & Co., Inc. supra at 91,683-84.

Brecher's advice. It is important that the testimony be set forth at length:

"[Mr. Brecher]: I believe that the same conversation subsequently ensued with Peter Aaron, but it first occurred with Ed Aaron. The gist of the conversation was the same with both people, that is, that where they are making a market in the stock if a customer wants to sell shares under the Rule 144 exemption, that they should refer that customer to a different broker and not sell it themselves, they should tell their customer that because they are a market maker they did not want-- and solely for that reason, I was trying to help them not lose the customer by telling them that they should specifically.... give the customer several brokers' name, if they asked.

Q. And with respect to certain low priced securities, did you discuss with them the use of brokerage houses located outside New York?

A. Yes. That topic came up and I thought that was certainly a laudatory thing to do in view of the fact that the customer would then save the taxes that would be incurred if they were sold in New York.

MR. MANDEL: Objection, and I move to strike. We are back to the tax problem again.

THE COURT: No. I'll allow it.

Q. And then did you speak to the Aarons about subsequently purchasing such stock as a market maker from the broker that was acting as the seller's agent?

MR. MANDEL: Objection to the form of the questions, your Honor. Which stock are we talking about?

MR. HECHT: Any Rule 144 stock.

MR. MANDEL: Rule 144 stock.

A. Well, I think the gist of our conversation was-- I don't remember the exact words, but that if they were staying in as a market maker, and if the customer went to another broker and sold the Rule 144 shares, there was nothing, in my opinion, improper about them continuing in their market making capacity, and if that broker sold the shares into the open market and chose to sell to E. L. Aaron & Company that would not necessarily be a violation of Rule 144, in my opinion.

MR. HECHT: I have no further questions."^{83/}

On cross examination, Mr. Brecher was even more specific in stating that, in his opinion, it was perfectly legal and proper for E. L. Aaron & Co., Inc. to arrange the transactions with a selling broker which would in turn sell the shares to E. L. Aaron & Co., Inc.;

"Q. Did you discuss with Peter Aaron whether or not E. L. Aaron & Co. could arrange with the selling broker, to whom they referred this selling stockholder, to purchase the stock?

A. Yes.

Q. And what was your discussion in that connection?

A. That it was perfectly proper. If it was consistent with marketmaking actions, perfectly proper.

Q. Well, what do you mean 'if it was consistent with marketmaking'?

A. If they were marketmakers in the stock, they could do so.

Q. They could do what?

A. They could do the actions that you just described in your questions. That would be proper.

Q. They could go out and contact this selling broker to whom they had referred this selling stockholder?

A. That's right.

Q. And purchase the stock?

A. That's right." 84/

The testimony clearly establishes that the District Court findings are unsupported in light of the weight of the evidence presented. It is inconceivable that the District Court could have found that the Appellant did not follow the opinion of counsel; a fortiori, it is impossible to find any reckless disregard of the illegality of the transaction, any intent to deceive, manipulate or defraud, i.e., any scienter.

This conclusion is inescapable when compared with recent cases determining that scienter is a necessary requirement for injunctive relief. In SEC v. American Realty Trust, (supra) the Court found that defendants made a material omission by failing to include in their Form 10-K all material facts relating to a particular loan arrangement. Nevertheless, the Court dismissed the action, finding that "A careful examination of the record in this

84/ Transcript, p. 490.

case leads the Court to conclude that defendants did not possess the requisite intent to deceive, manipulate or defraud. (emphasis added). The SEC has established but one instance in which defendants made a material omission or misstatement in any of the documents subject to SEC regulation. The omission was corrected in the 1974 and 1975 reports filed on Form 10-K." ^{85/}

Indicative and dispositive of the Appellant's lack of scienter to defraud is SCHREIBER's testimony:

"Q. At the time you made those statements with respect to the car to customers, did you believe them to be true?

A. Oh, emphatically.

MR. SCHIEREN: Objection, Your Honor.

THE COURT: It is immaterial, isn't it?

MR. HECHT: Your Honor, I think intent is a test under Ernst and Ernst v. Hochfelder and then in the Bausch & Lomb case down here.

THE COURT: He is not involved in this. He has already agreed to an affirmative injunction.

MR. HECHT. Right. But their complaint alleges that the only potential liability of Peter Aaron is as an aider and abettor.

MR. HECHT: And he consented, without admitting or denying it. And if there was no primary violation, then how can he be enjoined from aiding and abetting something that wasn't a violation 10b-5?

THE COURT: All right." ^{86/}

85/ SEC v. American Realty Trust, supra at p. 91,440.

86/ Transcript, pp. 401-402.

SCHREIBER testified, as set forth above, that he "empna-
tically" believed the statements made to him concerning the car to
be true. How then does the District Court find any "intent to
deceive, manipulate or defraud"? And, even further removed, how
does the District Court find any "intent to deceive, manipulate
or defraud" with respect to AARON who relied upon a person who
"emphatically" believed statements made to him to be true.

As in American Realty Trust, Hochfelder, Malik and Sanders, (supra)
this case presents another example of the lack of proof of the neces-
sary element: intent to deceive, manipulate or defraud. It is
undisputed that AARON conversed many times with his attorney con-
cerning the proper manner of performing Rule 144 transactions; it is
also undisputed that he discussed the matter of the representations
being made by JACOBSON and SCHREIBER and that he believed the repre-
sentations being made to be true, based on the representations
made directly to him by DANIEL DORFMAN, who was, at all times, the
principal stockholder of LAM and who was also at various times the
President of LAM.

Under the better reasoned present Federal Securities Laws
decisions, it is clear that a mistake (negligence) does not neces-
sarily doom an individual and end his career in the securities
business. AARON has been in the securities business for 18 years;
since he was 16 years old. In the face of clear evidence that he
used his best judgment in securing legal and factual advice, from
his attorney and from others, the District Court's enjoining AARON
is contrary to law, against the clear weight of the evidence and

unfair. If the Court enjoins negligent behavior which, by its definition, is inadvertent, a defendant may be in contempt of Court for unintentional behavior.

VI. INJUNCTIVE RELIEF IS INAPPROPRIATE IN THIS
CASE AND MUST BE REVERSED, AS BEING GRANTED
ON AN ERRONEOUS BASIS

The standard governing the issuance of an injunction in SEC enforcement actions is whether there is a reasonable likelihood that the violations will be repeated.^{87/}

However, not only must such a reasonable likelihood be shown, it must be shown on relevant and correct factual allegations. In this respect, this Court of Appeals must reverse this case based upon the SEC's attempt to influence the Trial Court by entering inadmissible and untruthful allegations regarding transactions in another security, namely, Cardiodynamics, Inc.^{88/} However, the SEC failed to state that the proceeding in that case was before the NASD, and that AARON, himself, was not even named in that proceeding. Thus, the statement that "Peter Aaron had engaged in other conduct in violation of the securities laws. Specifically, just as he (Aaron) did in connection with the sales of unregistered shares of LAM in this case, Peter Aaron arranged...."^{89/} is blatantly untrue. If AARON had in fact engaged in such conduct, why was he not named as a respondent by the NASD, or by the SEC in any other action?

The attempt by the SEC to have the Trial Court believe that AARON had engaged in illegal conduct in the past constitutes conduct by the Appellee which necessitates a reversal of the Trial Court's decision.

87/ SEC v. Culpepper, 270 f. 2d 241, 249-250 (2d. Cir. 1959); SEC v. Scott, Gorman Municipals, Inc., 407 F. Supp. 1383, 1387 (S.D.N.Y. 1975).

88/ SEC proposed Findings of Fact, Para. 51-53.

89/ Ibid., Para. 51

Moreover, AARON had been in the securities business for 18 years without any securities violation, a fact which the Trial Court ignored. What better evidence can there be negating the likelihood of future violations than an unblemished 18 year record?

The concept that AARON should be severely dealt with because of his "failure to recognize the wrongful nature of his conduct" ^{90/} is manifestly inapplicable here, where AARON sincerely questions the legal interpretations of the SEC with respect to Rule 144 and the duty of a mere employee at one office to supervise another branch office. It is unduly harsh to punish a defendant who raises legitimate issues of law where the facts are also very much in dispute, not to mention holding him responsible as an "aider and abettor" when there is not explicit statutory authority for holding so in SEC civil injunctive actions.

^{90/} SEC v. E. L. Aaron & Co., Inc., supra at 91,687.

VII. THE INJUNCTION SHOULD BE LIMITED TO THE
ONE SECURITY WHERE VIOLATIONS WERE FOUND

The Trial Court further erred in granting injunctive relief with respect to all securities. The reliance of the SEC on SEC v. Rega^{91/} is misplaced, since Rega held that the decision whether or not to grant an injunction is based upon finding a reasonable likelihood that the wrong will be repeated.^{92/} That case did not even address itself to the scope of the injunctive relief sought by the SEC. More appropriately, the Trial Court should have considered whether there was some tangible probability that the wrong will be repeated to justify the injunction.^{93/}

Again, one must look at AARON's 18 year record, free of securities violations, as well as the fact that the allegations in this case are limited to one security. These facts, plus the undisputed fact that AARON himself made no misrepresentations himself, militate very strongly against broad injunctive relief as to all securities.

The violations, if any, relate to one security, and the injunction, if any, should relate to one security. The Trial Court erred by ordering the entry of an overbroad injunction against the Appellant in what was not an egregious case or a flagrant case of misconduct or gross mis-management.

Lastly, in balancing the hardships between the parties and thereby properly resolving the equitable considerations in this

91/ SEC v. Rega, CCH Fed. Sec. L. Rep. 1975-1976 Transfer Binder ¶95,922 (S.D.N.Y. 1975).

92/ Ibid, at 98, 149.

93/ Ring v. Authors' League of America, 186 F. 2d 637 at 642-643 (2d. Cir. 1951).

matter, one must consider the lack of any proof of urgency, the threat of imminent harm to the public (i.e. when were the alleged violative acts committed), was the issuer already permanently enjoined, would the issuance of a preliminary injunction trigger mandatory disqualification from Regulation "A" offerings and thus be an "economic death penalty," and, although designated preliminary relief, would be final as to the defendant in other sections of the world. In the instant case, the balance falls clearly on the side of the Appellant.

CONCLUSION

In view of the error of the District Court in its findings regarding misrepresentations, the lack of any legal basis upon which to hold that PETER AARON had any duty to supervise other persons, the manifest compliance by AARON & CO. and, therefore, PETER AARON, with the provisions of Rule 144, the better reasoning of cases holding that scienter must be proven--and it cannot be proven in this case--the error in granting injunctive relief and the unfair scope of the injunction, it is respectfully requested that the findings of the District Court be reversed in this case.

October, 1977.

Respectfully submitted,

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On the Brief:

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JOHN LOWY

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss .

RICHARD WITHERS, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 1526 Webster Ave. Apt. B-3
Bronx, NY 10457.

That on the 26 day of OCTOBER, 1977,
deponent personally served the within BRIEF OF
DEFENDANT-APPELLANT PETER E. AARON
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

~~By leaving _____ true copies of same with a duly~~
~~authorized person at their designated office.~~

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

GLYNN MAYS, ESQ.
SECURITIES AND EXCHANGE COMMISSION
PLAINTIFF-APPELLEE
WASHINGTON, D.C. 20581

Richard Withers

Sworn to before me this
26 day of October, 1977

Michael DeSantis
MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Queens County
Commission Expires March 30, 1979